

# SARSEP CHECKLIST



This Checklist is *not* a complete description of all plan requirements, and should *not* be used as a substitute for a complete plan review.

## For Business Owner's Use

(DO NOT SEND THIS WORKSHEET TO THE IRS)

Every year it is important that you review the requirements for operating your Salary Reduction Simplified Employee Pension (SARSEP). This Checklist is a "quick tool" to help you keep your plan in compliance with many of the important tax rules. Underlined text below will link you to Internet information.

**1. Was your SARSEP established prior to January 1, 1997, and subsequently amended for current law?** Yes No

No new SARSEPs can be established after 1996. SARSEPs should be updated to benefit from the new law.

**2. Do you have 25 or fewer eligible employees?** Yes No

Only businesses with 25 or fewer eligible employees can contribute to a SARSEP.

**3. Are all employees who are at least age 21, worked for you in at least 3 of the last 5 years and have received at least \$450 during the year in compensation included in the plan?** Yes No

Employees of other businesses you and/or your family members own may have to be treated as employees when determining who is an eligible employee under the SARSEP.

**4. Are you determining each eligible employee's compensation using an appropriate definition in accordance with your 5305A-SEP document?** Yes No

Compensation used to determine contributions is limited to \$200,000 for 2003, \$205,000 for 2004, and is subject to cost-of-living adjustments in later years.

**5. Are all employee elective deferrals within the appropriate limit: \$12,000 for 2003, \$13,000 for 2004, \$14,000 for 2005?** Yes No

For employees age 50 or over, additional catch-up contributions of up to \$2,000 can be made for 2003, \$3,000 for 2004, and \$4,000 for 2005.

**6. Do 50% or more of all eligible employees make employee elective deferrals?** Yes No

At least half of your eligible employees must make employee elective deferrals to the SARSEP.

**7. Are total contributions (employee elective deferrals and nonelective employer contributions) no more than 25% of compensation?** Yes No

For 2002 and 2003, contributions are limited to the lesser of 25% of compensation or \$40,000. The dollar amount is adjusted annually for changes in the cost of living. The amount is \$41,000 for 2004. SARSEPs do not permit employers to make matching contributions to participants' accounts.

**8. Did you deposit employee elective deferrals timely?** Yes No

Employee elective deferrals must be remitted to the appropriate financial institution as soon as possible but, in any event, no later than 15 days following the month in which the employee would have otherwise received the money.

**9. Did you perform the annual average deferral percentage test?** Yes No

The amount deferred each year by each highly compensated employee as a percentage of pay (the deferral percentage) cannot exceed 125% of the average deferral percentage of all eligible nonhighly compensated employees.

**10. Have you made required top-heavy minimum contributions to the SARSEP?** Yes No

Refer to your plan document for information. Most plans are deemed top-heavy, but some plans require annual testing.

**If you answered "No" to any of the above questions, you may have a mistake in the operation of your SARSEP. Many mistakes can be corrected easily, without penalty and without notifying the IRS.**

■ contact your benefits professional

■ visit the IRS at [www.irs.gov/ep](http://www.irs.gov/ep)

■ call the IRS at (877) 829-5500



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## **SARSEP**

A SARSEP is a simplified employee pension plan (SEP) set up before 1997 that includes a salary reduction arrangement. Under a SARSEP, employees can choose to have the employer contribute part of their pay to their Individual Retirement Accounts or Annuities (IRAs). This contribution is called an “elective deferral” or “employee elective deferral” because employees choose (elect) to set aside the money, and they defer the tax on the money until it is distributed to them.

In other words, it is the employees that decide whether, and to what extent, money will be paid to IRAs established for them under the SARSEP, rather than being paid to them as compensation. SARSEPs are similar in some respects to section 401(k) plans.

A SARSEP is a written arrangement that allows an employer to make contributions towards its employees' retirement without becoming involved in more complex retirement plans. A self-employed individual may also maintain a SARSEP. The contributions are made to traditional IRAs – not Roth or SIMPLE IRAs – of the plan participants. Under a SARSEP, IRAs are set up for each eligible employee.

### **1A. January 1, 1997:**

The Small Business Job Protection Act of 1996 (SBJPA) prospectively repealed SARSEPs. Therefore, no new SARSEPs can be established after December 31, 1996. However, employers that established SARSEPs prior to January 1, 1997, can continue to maintain them, and new employees of the employer hired after December 31, 1996, can participate in the existing SARSEP. The introduction of SIMPLE IRA plans under Internal Revenue Code section 408(p) (added to the Code by SBJPA) is intended to fill the need for retirement plans like SARSEPs.

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### **1B. Current Law:**

A SARSEP must be a written arrangement. As with regular SEPs, SARSEPs can be adopted using a model form, a prototype document or an individually designed document. Form 5305A-SEP, *Salary Reduction and Other Elective Simplified Employee Pension – Individual Retirement Accounts Contribution Agreement*, is the model SARSEP issued by the IRS. If a SARSEP is individually designed, it must have language that satisfies Internal Revenue Code section 408(k)(6).

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) changed many of the Internal Revenue Code's requirements and limits for qualified plans and IRAs. In order to maintain tax-advantaged status and benefit under these new provisions, SARSEP prototype and individually designed plans must be amended for current law. In order for employers with model SARSEPs to maintain tax-advantaged status and to avail themselves of new law changes, they must adopt the current version of the model Form [5305A-SEP](#). The current model Form 5305A-SEP has a revision date of March 2002.

The administrator of an amended SARSEP must furnish each participant – within 30 days of the amendment – a copy of the amendment and an explanation of its effects.

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### **2. 25 or fewer:**

Salary reduction contributions cannot be made to a SARSEP for a year if there were more than 25 employees who were eligible to participate at any time during the preceding year.

The 25-employee rule is a look-back rule. It is a year-by-year rule. For example, if you had 23 eligible employees in year 2002, but 27 eligible employees in year 2003, salary reduction contributions may be made to the SEP-IRAs of the 27 employees for 2003. However, in year 2004, no salary reduction contributions may be made for you and your employees.

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### 3. All Employees:

All eligible employees must be allowed to participate, including part-time employees and seasonal employees. An eligible employee is an employee who:

- Is at least 21 years of age.
- Has performed service for you in at least 3 of the immediately preceding 5 years.

The term “employee” includes a self-employed individual who has earned income and a working business owner.

Certain leased employees must be treated as “employees”.

Your SARSEP document can provide for less restrictive eligibility requirements (but not more restrictive ones). “Service” means any work performed for you for any period of time, however short. A SARSEP may not impose an hours-of-service requirement.

**Excludable employees:** The following employees do not need to be covered under a SARSEP:

- Employees covered by a union agreement whose retirement benefits were bargained for in good faith by you and their union.
- Nonresident alien employees who did not earn U.S. source income from you.
- Employees who received less than \$450 in compensation during the year. This amount is subject to [cost-of-living adjustments](#) after 2004.

Example 1: Employer X maintains a calendar year SARSEP. Under the SARSEP, an employee must perform service in at least 3 of the immediately preceding 5 years, reach age 21, and earn the minimum amount of compensation during the current year. Employee A worked for Employer X during his summer breaks from school in 2001, 2002, and 2003 but never more than 34 days in any year. In July 2004, Employee A turns 21. In August 2004, Employee A begins working for Employer X on a full-time basis. Employee A is an eligible employee in 2004 because he has met the minimum age requirement, has worked for Employer X in 3 of the 5 preceding years, and has met the minimum compensation requirement for 2004.

Example 2: Employer Y designs its SARSEP to provide for immediate participation regardless of age, service or compensation. Employee B is age 18, and begins working part-time for Employer Y in 2004. Employee B is an eligible employee for 2004.

Including Employees of Related Employers: “Employees” for purposes of determining who is an eligible employee under your SARSEP includes all employees of all related employers. Related employers include controlled groups of corporations that include your business, trades or businesses under common control with your business, and affiliated service groups that include your business. This means, for example, that if you and/or your family members own a controlling interest in another business, employees of that other business are “employees” for purposes of determining who is eligible to participate in a SARSEP.

**Example.** Individual P owns Business A, a computer rental agency that has 40 eligible employees. Individual P also owns Business B, which repairs computers and has 30 eligible employees. Individual P is the sole owner of both businesses. For purposes of the SARSEP rules, all 70 employees are treated as employed by a single employer.

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### 4. Notice Requirements:

You must give an employee the following information within a reasonable time after the later of the date the SARSEP is adopted and the date the employee becomes employed:

- 1) Notice that the SARSEP has been adopted,
- 2) Requirements an employee must meet to receive an contribution, and
- 3) The basis upon which the employer’s contributions will be allocated.

This notification requirement can be satisfied by providing your employees with a copy of the SARSEP agreement (Form 5305A-SEP), its instructions and the other information listed in the Form 5305A-SEP instructions, if a model SARSEP has been adopted. If you use a prototype or individually designed SARSEP, similar information must be provided.

Failure to furnish the above information within a reasonable time subjects you to a \$50 penalty per failure, unless the failure is due to reasonable cause.

In addition, each year, you must furnish an annual statement to each employee participating in the SARSEP that shows the amount contributed to their SEP-IRA for that year. This annual reporting must be provided to the employee no later than the January 31 following the calendar year for which the report relates. Note: Often [Form 5498](#), *IRA Contribution Information*, is used for this purpose.

Failure to furnish an annual statement showing the amount contributed subjects you to a \$50 penalty per failure, unless the failure is due to reasonable cause.

**Reporting on Form W-2:** Do not include employee elective deferrals in the “Wages, tips, other compensation” box of Form W-2. You must however, include them in the “Social security wages” and Medicare wages and tips” boxes. You must also include them in box 12. Mark the “Retirement plan” checkbox in box 13. For more information, see the Form W-2 instructions.

General Reporting Requirements:

In addition to the employee notification requirements above, the bank, insurance company or other trustee or issuer of the SEP-IRAs must comply with the following general reporting requirements.

- 1) [Form 5498](#) must be submitted to the IRS by the trustee or issuer of a SEP-IRA to report contributions to the SEP-IRA. A separate Form 5498 must be submitted for each SEP participant. This form or other statement of fair market value and account activity must also be given to participants.
- 2) [Form 1099-R](#), *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.* is used to report distributions from a SEP-IRA. Distributions from a SEP-IRA are subject to the same withholding rules that apply to distributions from traditional IRAs. See [Publication 590](#), *Individual Retirement Arrangements (IRAs)*, for details on IRA distribution rules.

SARSEP Notice and Reporting Requirements:

In addition to the notice and reporting requirements described above, SARSEPs have special notice and reporting requirements when the IRC section 408(k)(6) limits on employee elective deferrals are not satisfied. Notice 89-32 (1989-1 C.B. 671.) sets forth the reporting requirements in these situations. See Average Deferral Percentage Test below.

Form 5500:

The Form 5500, *Annual Return/Report of Employee Benefit Plan*, that is required to be filed by most qualified retirement plans is generally not required for SARSEPs. SARSEPs are exempt from the Department of Labor’s reporting and disclosure requirements provided the employer satisfies certain employee notice requirements and does not impose investment restrictions on monies contributed to employees’ SEP-IRAs.

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## **5A. Employee Elective Deferrals:**

As in 401(k) plans, contributions funded pursuant to salary reduction elections are called “elective deferrals” or “employee elective deferrals” because the contributions are made at the election of the employee and because the principal tax effect is to defer payment of income taxes until the money is actually distributed to the employee from the SEP-IRA.

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## **5B. Appropriate limit:**

Limit on Employee Elective Deferrals:

The most a participant can choose to defer for the 2003 calendar year is the lesser of:

- 1) 25% of the participant's compensation (limited to \$200,000), or
- 2) \$12,000.

The compensation limit in (1) is \$205,000 in 2004 and is subject to [cost-of-living adjustments](#) for later years. The amount in (2) increases to \$13,000 for 2004, \$14,000 for 2005, and \$15,000 for 2006 and later years. After 2006, the limit is subject to cost-of-living adjustments. The \$12,000 limit applies to the total employee elective deferrals the employee makes for the year to a SARSEP and any of the following:

- Cash or deferred arrangement (section 401(k) plan).
- Salary reduction arrangement under a tax-sheltered annuity plan (section 403(b) plan).
- SIMPLE IRA plan.

Overall limit on SARSEP contributions:

The total of the nonelective and elective contributions for any participant cannot exceed the lesser of 25% of the employee's compensation or \$40,000 for 2003 (\$41,000 for 2004 and subject to [cost-of-living adjustments](#) for later years). The same rule applies to contributions you make for yourself. For figuring the 25% limit on elective deferrals, compensation does not include SARSEP contributions, including elective deferrals or other amounts deferred in certain employee benefit plans.

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## **5C. Catch-up contributions:**

In the case of an eligible employee who is 50 or older before the end of the calendar year, an additional amount of compensation ("catch-up elective deferral contributions") may be deferred during the year. The limit on catch-up elective deferral contributions is \$2,000 for 2003, \$3,000 for 2004, \$4,000 for 2005, and \$5,000 for 2006 and later years. After 2006, the limit is subject to [cost-of-living adjustments](#).

Employee elective deferrals are not treated as catch-up contributions until they exceed the elective deferral limit (the lesser of 25% of compensation or \$12,000 for 2003 (\$13,000 for 2004)), the SARSEP Average Deferral Percentage test discussed below, or the plan limit (if any). However, the catch-up contributions a participant can make for a year cannot exceed the lesser of the following amounts:

- The catch-up contribution limit.
- The excess of the participant's compensation over the employee elective deferrals that are not catch-up contributions.

Catch-up contributions are not subject to the employee elective deferral limit (the lesser of 25% of compensation or \$12,000 for 2003 (\$13,000 for 2004)).

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## **6. 50% or more of all Eligible Employees:**

A SARSEP must be set up before 1997 and must meet the following requirements each year:

- 1) You must have 25 or fewer employees who were eligible to participate in the SARSEP in the preceding year;
- 2) At least 50% of your eligible employees must choose to make employee elective deferrals this year; and
- 3) The employee deferrals of your highly compensated employees must satisfy the SARSEP Average Deferral Percentage test discussed below.

If fewer than 50% of your eligible employees choose to make employee deferrals to the SARSEP for a year, all employee deferrals made for that year are disallowed and must be withdrawn from the employees' SEP-IRAs. By March 15<sup>th</sup> of the following year, you must notify each affected employee of:

- 1) The amount of the disallowed deferrals to their SEP-IRA for the preceding calendar year,
- 2) The calendar year the disallowed deferrals and earnings are includible in gross income,
- 3) Information stating that the employee must withdraw the excess contributions (and earnings), and
- 4) An explanation of the tax consequences if the employee does not withdraw such amounts.

See the Instructions for [Form 5305A-SEP](#) for detailed information on how to treat disallowed deferrals.

This is a year-by-year rule. Each year the 50% rule is not met, employee elective deferrals for that year cannot remain in the employees' SEP-IRAs.

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#### **7A. Contributions:**

Depending on the terms of your SARSEP, you may be able to make nonelective contributions in addition to employee elective deferrals to the SEP-IRAs of your employees subject to an annual limit. If you are self-employed, you can contribute to your own SEP-IRA.

Contributions must be in the form of money (cash, check, or money order). You cannot contribute property, except in a rollover. See Publication 590 for more information about rollovers.

Once you make a SARSEP contribution to an employee's SEP-IRA, it is owned by the employee and cannot be made subject to a vesting schedule or taken back by you.

Matching contributions are not permitted in a SARSEP.

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#### **7B. Compensation:**

An appropriate definition of compensation must be used to determine the amount of contributions. This compensation cannot exceed \$200,000 in 2003 (\$205,000 in 2004 and subject to [cost-of-living adjustments](#) for later years). The definition of compensation stated in the document must be consistently followed in the operation of the plan. Compensation generally includes the pay a participant received from you for personal services for a year including:

- 1) Wages and salaries.
- 2) Fees for professional services.
- 3) Other amounts received (cash or non-cash) for personal services actually rendered by an employee, including, but not limited to, the following items.
  - a) Commissions and tips.
  - b) Fringe benefits.
  - c) Bonuses.

If you are a self-employed individual, compensation means your earned income, or net earnings from self-employment from a business in which your services materially helped to produce the income.

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#### **7C. Lesser of 25% of compensation or \$40,000:**

The annual contribution limit is the lesser of 25% of the employee's compensation limited to \$200,000 for 2003 (\$205,000 for 2004 and subject to [cost-of-living adjustments](#) for later years) or \$40,000 for 2003, (\$41,000 for 2004 and subject to cost-of-living adjustments for later years). In determining this limit, you must include the amounts deferred by the employee and the nonelective contributions you make to the SEP-IRA. In addition, contributions made on behalf of an employee to another defined contribution plan you sponsor must be included for purposes of the annual contribution limit. The same rule applies to contributions you make to your own SEP-IRA.

The most you may deduct on your business tax return for your contributions to your employees' SEP-IRAs is the lesser of your contributions or 25% of compensation. For this purpose, compensation is limited to \$200,000 (\$205,000 for 2004 and subject to [cost-of-living adjustments](#) for later years). If you are a self-employed individual, when figuring the deduction for contributions made to your SEP-IRA, compensation is your net earnings from self-employment which takes into account the following deductions; (a) the deduction for one-half of your self-employment tax and (b) the deduction for contributions to your own SEP-IRA. See [Publication 560, Retirement Plans for Small Business \(SEP, SIMPLE, and Qualified Plans\)](#) for details on determining your deduction. If your SARSEP plan document specifies lower contribution limits, then the lower limits control.

SARSEP contributions by corporate employers are deducted on Form 1120, *U.S. Corporation Income Tax Return*. Employers who are sole proprietors may deduct contributions on Schedule C of Form 1040, Profit or Loss From Business and deduct contributions made for themselves on Form 1040, U.S. Individual Income Tax Return. Partnerships deduct contributions made for common-law employees on Form 1065, U.S. Return of Partnership Income; but report on Schedule K-1, Partner's Share of Income, Credits, Deductions, etc. contributions made for partners, who deduct such contributions on their own returns.

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### **8. Timely Deposit:**

You must forward employee elective deferrals to the financial institution as soon as they can be reasonably segregated from the employer's general assets, but in no event later than 15 business days following the month they were withheld from the employee's paycheck. See Department of Labor Regulation Section 2510.3-102.

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### **9. Average Deferral Percentage Test:**

SARSEPs are subject to a nondiscrimination test similar to the annual test imposed on section 401(k) plans. This test limits the amount your highly compensated employees can defer based on what your nonhighly compensated employees defer into the SARSEP. The deferral percentage limit for your highly compensated employees is computed by first averaging the deferral percentages for the nonhighly compensated employees for the year and then multiplying this result by 1.25. The deferral percentage limitation must be computed each year. See the Instructions for [Form 5305A-SEP](#) for this computation.

The deferral percentage test for SARSEPs compares the deferral percentage of each HCE with the average of the deferral percentages of all other employees – not the average of the deferral percentages of all HCEs with the average of all other employees (as in a section 401(k) plan). Further, unlike section 401(k) plans, nonelective contributions from the employer cannot be used to help the SARSEP satisfy the annual test.

If a highly compensated employee has exceeded the deferral percentage limit for a year, the employee must withdraw those excess contributions by April 15 following the calendar year in which the employee is notified. Excess contributions not withdrawn by April 15 will be subject to the IRA contribution limits of Internal Revenue Code sections 219 and 408 and may be considered excess contributions to the employee's IRA. For the employee, these excess contributions are subject to a 6% tax on excess contributions under Internal Revenue Code section 4973. Income on excess elective deferrals is includible in the employee's income in the year it is withdrawn from the IRA. The income must also be withdrawn by April 15 following the calendar year of notification. If the income is withdrawn after that date and the recipient is not 59 ½ years of age, it may be subject to the 10% tax on early distributions under section 72(t).

If the deferral percentage limitation is exceeded, you must notify each affected employee by March 15<sup>th</sup> of the following year of:

- 1) The amount of the excess contributions to their SEP-IRA for the preceding calendar year,
- 2) The calendar year the excess contributions and earnings are includible in gross income,
- 3) Information stating that the employee must withdraw the excess contributions (and earnings), and
- 4) An explanation of the tax consequences if the employee does not withdraw such amounts.

See the Instructions for [Form 5305A-SEP](#) for a detailed description of the notification procedures.

**Highly compensated employee.** A highly compensated employee is an individual who:

- Owned more than 5% of the capital or profits in your business at any time during the year or the preceding year, or
- For the preceding year, received compensation from you of more than \$90,000 and, if your SARSEP document so provides, was in the top 20% of employees when ranked by compensation. The \$90,000 amount in the preceding sentence is the amount applicable to years 2002 through 2004.

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#### **10. Top-Heavy Minimum:**

A minimum contribution is required to be made for non-key employees whenever the SARSEP is top-heavy. A SARSEP is top-heavy when more than 60% of all employer contributions go to key employees. But since many SARSEPs are always top-heavy, SARSEPs are often drafted to operate as if they were always top-heavy, thereby eliminating the need to make the annual 60% determination.

For purposes of determining if a plan is top-heavy, employee elective deferrals are considered employer contributions. Employee elective deferrals may not be used, however, to satisfy the minimum contribution requirements for top-heavy plans. For purposes of determining the top-heavy minimum contribution, employee elective deferrals made by key employees must be counted.

The employer will satisfy the top-heavy requirements by making a minimum contribution each year to the SEP-IRA of each employee eligible to participate in this SARSEP. This minimum contribution is not required for key employees. This contribution, in combination with other nonelective contributions, is equal to the lesser of:

- 3% of each eligible non-key employee's compensation or
- The percentage of compensation at which elective (not including catch-up elective deferral contributions) and nonelective contributions are made under this SARSEP (and any other SEP maintained by the employer) for the year for the key employee with the highest percentage for the year.

A key employee is any employee who, at any time during the preceding year was:

- An officer of the employer with compensation greater than \$130,000 (subject to [cost-of-living adjustments](#)),
- A 5% owner of the employer, as defined in section 416(i)(1)(B)(i) of the Internal Revenue Code, or
- A 1% owner of the employer with compensation greater than \$150,000.

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